The
American Economic Review

VOL. IV MARCH, 1914 No. 1

THE FEDERAL RESERVE ACT

The Federal Reserve Act, signed by President Woodrow Wilson on December 23, 1913, has already aroused much criticism, many different expressions of opinion, and elaborate discussion of details. Great political prejudice has been engendered. Throughout the past year the discussion has been almost continuous, at first in a limited number of publications and in technical circles, then in the secular press, on the platform, and generally throughout the country. Taking the debate on the so-called money trust question as the precursor of that which dealt with banking legislation, in the proper sense of the term, the controversy in Congress has also been well nigh continuous for the past year. As a result of this twelve months effort, roundly speaking, and of the preliminary work which had gone before, the country has today on the statute books, a law much more inclusive and incisive than any that has been adopted since the passage of the national bank act in 1863-1864. Indeed, the new measure is more far-reaching than the national banking act itself, since the latter was primarily a change in the method of issuing currency, while the Federal Reserve Act is not only that, but is also a radical transformation of the methods employed in the creation of bank credits. It is not likely that the Federal Reserve Act will become fully effective save after a considerable period of further criticism and analysis. What the act means, how it has come into existence, its relation to banking proposals past and present, and the methods by which its adoption has been secured, as well as the opposition from which it has suffered heretofore and will suffer in the future, are, therefore, of fundamental interest not only as a matter of history and current politics but as an element in the further development of American banking legislation. The present study can afford only a general sketch of these varying phases of the measure, but it will endeavor to set forth some of the more salient elements in the situation.

No current economic issue has received more attention of a

certain sort than currency and banking, during the past few years of American politics. Beginning with the struggle for "sound money" in 1896 and 1900, the debate gradually shifted to the field of banking reform; and during the decade just past consideration of the question at bankers' conventions, at meetings of business men, and elsewhere, has been almost constant. While the issue has not taken, in recent years at least, a strong hold upon the popular interest or imagination, it has been the topic of unremitting study and controversy among the more intelligent classes in the community as well as among the business and banking interests of higher grades and, as every student of theory knows, among professional economists. To dispassionate observers, indeed, it has sometimes seemed that the banking question had become, or was in danger of becoming, a largely academic matter—a subject of forensic disputation; as to which, debate was bitter and controversial, but with reference to which, few seriously expected any definite action within a reasonable future, while none looked for immediate legislation designed to close the issue once and for all. At least one result of the prolonged controversy has been witnessed during the past three years in the expenditure of probably about $1,000,000 in actual direct outlay for the purpose of securing legislation. This vast sum, expended partly for governmental investigations, partly for organized agitation, and partly in the promotion of meetings, conventions, and other occasions for debate, must be regarded as having had its primary result in the creation of a helpful public opinion and understanding of the fundamentals of banking.

Yet those who believed that, in consequence of this extended discussion of the subject, there would be a smoothing of the path for legislative action have found themselves profoundly mistaken. Neither from the banking community as such, from organizations of business men, from the press, or from the professional economists of the country taken as a body has aid been received by those who were engaged in the task of framing and enacting the proposed currency and banking legislation. Honorable and distinguished exceptions in each of the classes or groups just enumerated spring at once to mind, but in the main the remark will hold true. The currency and banking law of 1913 had to be pressed forward to a passage over the all but united opposition of those who had been engaged in the popularizing of "sound" ideas on currency and banking and in the voicing of a demand for action,

notwithstanding that it embodies, and at every stage of its progress has embodied, the essential ideas regarded as fundamental by thoughtful students of the problem with which it deals. Selfish interests entwined about an obsolete and injurious system of banking have striven their utmost to discredit the legislation and to place obstacles in the path of its advocates; supposed experts have lent their services to the defense of the worse elements in the existing situation; and the press has too often done what it could both to misrepresent the facts and to discredit the motives of those who were honestly laboring for the fundamentals of reform. That under these conditions and in spite of them the Federal Reserve Act has been passed, some of the older conditions remedied, and a way opened to the very great improvement of American banking, both from the technical and from the broader point of view, is primarily due to the honesty and sincerity of the House leaders entrusted with the duty of presenting a reform measure, to the constant and courageous coöperation of the Treasury and its chief, and above all to the unwavering determination and keen insight of the Executive. Secondarily, the result shows the capacity of the dominant party for discipline and leadership and its power to shake off false traditions and past mistakes.

I

A brief outline sketch of the legislative history of the Federal Reserve Act may first be presented.[1] Without at present entering into the early history of the process by which the measure itself was framed, between April, 1912, and June, 1913, it may be generally said that during the period referred to a preliminary draft of what later became the Federal Reserve Act was shaped under the auspices, first of a sub-committee of the House Banking and Currency Committee as organized in the Sixty-second Congress, Hon. Carter Glass of Virginia being chairman of the sub-committee in question, and then under the auspices of Mr. Glass himself as the ranking Democratic member and prospective chairman of the banking and currency committee to be organized in the House of Representatives of the Sixty-third Congress.

Upon the basis of careful investigation, conducted under di-

[1] Much of this history, in its greatest significance, is not a matter of record, since the events which formed the principal parts of it occurred behind closed doors in the party caucus, or during consultations of legislative leaders. No complete review of these events and phases in the history of the bill will be undertaken within the scope of this paper.

rection and supervision of the committee, partly at public hearings during the winter of 1912-1913, partly by private investigations, it had been determined what features should and what points should not be embodied in the proposed measure. The bill thus drafted had been submitted to and had received the approval of President Woodrow Wilson, and was thus, when introduced in the House of Representatives on June 18, an administration bill in the sense that it had received the approval of those charged with administrative responsibility, while it had been developed by the authorized legislative agencies of Congress. As thus drafted for presentation, the banking bill covered certain main points, which were subjected to no serious change and which have been succinctly reviewed in a report, submitted to the House on September 9, 1913, by Chairman Glass on behalf of the Banking and Currency Committee, as follows:[2]

After looking over the whole ground, and after examining the various suggestions for legislation, some of which have just been outlined, the Committee on Banking and Currency is firmly of the opinion that any effective legislation on banking must include the following fundamental elements, which it considers indispensable in any measure likely to prove satisfactory to the country:

1. Creation of a joint mechanism for the extension of credit to banks which possess sound assets and which desire to liquidate them for the purpose of meeting legitimate commercial, agricultural, and industrial demands on the part of their clientele.

2. Ultimate retirement of the present bond-secured currency, with suitable provision for the fulfillment of Government obligations to bondholders, coupled with the creation of a satisfactory flexible currency to take its place.

3. Provision for better extension of American banking facilities in foreign countries to the end that our trade abroad may be enlarged and that American business men in foreign countries may obtain the accommodations they require in the conduct of their operations.

Beyond these cardinal and simple propositions the committee has not deemed it wise at this time to make any recommendations, save that in a few particulars it has suggested the amendment of existing provisions in the national-bank act, with a view to strengthening that measure at points where experience has shown the necessity of alteration.

In order to meet the requirements thus sketched, the committee proposes a plan for the organization of reserve or rediscount institutions to which it assigns the name "Federal reserve banks." It recommends that these be established in suitable places throughout the country to the number of 12 as a beginning, and that they be assigned the function of bankers' banks. Under the committee's plan these

[2] *H. Rept.*, 63 Cong., 1 Sess., pp. 16 *et seq.*

banks would be organized by existing banks, both National and State, as stockholders. It believes that banking institutions which desire to be known by the name "national" should be required, and can well afford, to take upon themselves the responsibilities involved in joint or federated organization. It recommends that these bankers' banks shall be given a definite capital, to be subscribed and paid by their constituent member banks which hold their shares, and that they shall do business only with the banks aforesaid, and with the Government. Public funds, it recommends, shall be deposited in these new banks which shall thus acquire an essentially public character, and shall be subject to the control and oversight which is a necessary concomitant of such a character. In order that these banks may be effectively inspected, and in order that they may pursue a banking policy which shall be uniform and harmonious for the country as a whole, the committee proposes a general board of management intrusted with the power to overlook and direct the general functions of the banks referred to. To this it assigns the title of "The Federal Reserve Board." It further recommends that the present national banks shall have their bonds now held as security for circulation paid at the end of 20 years, and that in the meantime they may turn in these bonds by a gradual process, receiving in exchange 3 per cent bonds without the circulation privilege.

In lieu of the notes, now secured by national bonds and issued by the national banks, and, so far as necessary in addition to them, the committee recommends that there shall be an issue of "Federal reserve treasury notes," to be the obligations of the United States, but to be paid out solely through Federal reserve banks upon the application of the latter, protected by commercial paper, and with redemption assured through the holding of a reserve of gold amounting to 33 1/3 per cent of the notes outstanding at any one time. In order to meet the requirements of foreign trade, the committee recommends that the power to establish foreign branch banks shall be bestowed upon existing national banks under carefully prescribed conditions and that Federal reserve banks shall also be authorized to establish offices abroad for the conduct of their own business and for the purpose of facilitating the fiscal operations of the United States Government. Finally and lastly, the committee suggests the amendment of the national-bank act in respect to two or three essential particulars, the chief of which are bank examinations, the present conditions under which loans are made to farming interests, and the liability of stockholders of failed banks. It believes that these recommendations, if carried out, will afford the basis for the complete reconstruction and the very great strengthening and improvement of the present banking and credit system of the United States. The chief evils of which complaint has been made will be rectified, while others will at least be palliated and put in the way of later elimination.

The Federal reserve banks suggested by the committee as just indicated would be in effect coöperative institutions, carried on for the benefit of the community and of the banks themselves by the

banks acting as stockholders therein. It is proposed that they shall have an active capital equal to 10 per cent of the capital of existing banks which may take stock in the new enterprise. This would result in a capital of something over $100,000,000 for the reserve banks taken together if practically all existing national banks should enter the system. It is supposed, for a number of reasons, that the banks would so enter the system. More will be said on this point later in the discussion. How many State banks would apply for and be granted admission to the new system as stockholders in the reserve banks can not be confidently predicted. It may, however, be fair to assume at this point that the total capital of the reserve banks will be in the neighborhood of $100,000,000. The bill recommended by the committee provides for the transfer of the present funds of the Government included in what is known as the general fund to the new Federal reserve banks, which are thereafter to act as fiscal agents of the Government. The total amount of funds which would thus be transferred can not now be predicted with absolute accuracy, but the released balance in the general fund of the Treasury is not far from $135,000,000. Certain other funds now held in the department would in the course of time be transferred to the banks in this same way, and that would result in placing, according to the estimates of good authorities, an ultimate sum of from $200,000,000 to $250,000,000 in the hands of the reserve banks. If the former amount be assumed to be correct, it is seen that the reserve banks would start shortly after their organization with a cash resource of at least $300,000,000. As will presently be seen in greater detail, it is proposed to give to the reserve banks reserves now held by individual banks as reserve holders under the national banking act for other banks. Confining attention to the national system, it is probable that the transfer of funds thus to be made by the end of a year from the date at which the new system would be organized would be in the neighborhood of $350,000,000. If State banks entered the system and conformed to the same reserve requirements they would proportionately increase this amount, but for the sake of conservatism the discussion may be properly confined to the national banks. For reasons which will be stated at a later point, it seems likely that at least $250,000,000 of the reserves just referred to would be transferred to the reserve banks in cash; and if this were done the total amount of funds which they would have in hand would be at least $550,000,000. This would create a reservoir of liquid funds far surpassing anything of similar kind ever available in this country heretofore. It would compare favorably with the resources possessed by Government banking institutions abroad.

It will be observed that in what has just been said the reserve banks have been spoken of as if they were a unit. The committee, however, recommends that they shall be individually organized and individually controlled, each holding the fluid funds of the region in which it is organized and each ordinarily dependent upon no other part of the country for assistance. The only factor of centralization which has been provided in the committee's plan is found in the Federal Reserve

Board, which is to be a strictly Government organization created for the purpose of inspecting existing banking institutions and of regulating relationships between Federal reserve banks and between them and the Government itself. Careful study of the elements of the problem has convinced the committee that every element of advantage found to exist in coöperative or central banks abroad can be realized by the degree of coöperation which will be secured through the reserve-bank plan recommended, while many dangers and possibilities of undue control of the resources of one section by another will be avoided. Local control of banking, local application of resources to necessities, combined with Federal supervision, and limited by Federal authority to compel the joint application of bank resources to the relief of dangerous or stringent conditions in any locality are the characteristic features of the plan as now put forward. The limitation of business which is proposed in the sections governing rediscounts, and the maintenance of all operations upon a footing of relatively short time will keep the assets of the proposed institutions in a strictly fluid and available condition, and will insure the presence of the means of accommodation when banks apply for loans to enable them to extend to their clients larger degrees of assistance in business. It is proposed that the Government shall retain a sufficient power over the reserve banks to enable it to exercise a directing authority when necessary to do so, but that it shall in no way attempt to carry on through its own mechanism the routine operations of banking which require detailed knowledge of local and individual credit and which determine the actual use of the funds of the community in any given instance. In other words, the reserve-bank plan retains to the Government power over the exercise of the broader banking functions, while it leaves to individuals and privately owned institutions the actual direction of routine.

As first presented, the bill was taken in hand by the House Committee on Banking and Currency, which, however, had not been named until a few days previous to the introduction of the measure. The committee held its first meeting on June 6; then began the active work of considering the bill on July 7; and continued regular sessions several hours each day until the beginning of September. The bill was then reported to a Democratic caucus, and after about two weeks of discussion behind closed doors was ratified, and was thereupon formally reported, on September 9, to the House of Representatives, where it was taken under debate on September 10, and ultimately forced to a passage in the House on September 18. It was then sent to the upper chamber and was taken under advisement in the Senate banking committee where extensive hearings were promptly begun and were continued until October 25. Thereafter, a month of consideration in committee ensued, and subsequently three days of caucus consideration in

the Senate, a final report to the Senate as such being rendered on December 1. Debate then began and was continued, first in the intervals of business already scheduled, then at practically continuous sessions until December 19 when a final vote was secured and the measure within twenty-four hours sent to conference, from which it emerged on December 22, receiving, as already stated, the President's signature on the following day.

When reported by the Senate banking committee, after its own consideration and that of the caucus, the banking bill contained no important changes in theory, as compared with the House draft, save only in the section which related to the method of retiring existing national bank circulation and of providing for the refunding of United States 2 per cent bonds. The bill, however, differed essentially from the House measure in many details, some of them of great importance, others of minor significance. The framework of the bill had been changed in no fundamental particular, but remained as it had been originally constructed. The detailed changes, taken in the aggregate, would, however, have altered in a considerable degree its scope and effect. A sketch of these changes must, therefore, be presented at this point.

As reported by the Senate committee, the bill, instead of providing for a series of reserve banks not less than 12 in number, whose stock was to be owned exclusively by existing national and state banks, provided for not less than 8 nor more than 12 of such banks, and permitted the stock, if not taken up by existing banks through subscription, to be sold to the public, or, if not subscribed for by the public, to be allotted to the United States government. It slightly altered the method of voting for directors of reserve banks, from the plan prescribed in the House bill. It relieved the national banks entering the system of the necessity of rechartering. The Federal Reserve Board was somewhat changed in composition, through the elimination of one ex-officio member drawn from the administration, and was given broader and less restricted powers than had been conferred by the House bill, although none of a new or fundamental nature were added. The Senate committee, moreover, instead of making the deposit of public funds in reserve banks mandatory, left it to the discretion of the Secretary of the Treasury to deposit such funds or not as he might see fit, although the tenor of the provision on this subject was such as to indicate that the declared policy of the United States would in the future be that of making

the deposits with the reserve banks rather than with national banks as in the past.

As a method of retiring United States bonds and national bank circulation, the Senate bill provided that these securities might be annually assigned to federal reserve banks in a sum not to exceed $25,000,000, the banks to be required to purchase the bonds at par from their existing owners and to issue upon them, as security, notes exactly similar to existing national bank notes and subject to the same requirements, limitations, and obligations.

In dealing with the reserve question, it was provided that federal reserve banks should maintain 35-40 per cent instead of 33 1/3 per cent as in the House bill, and that national banks should maintain in central reserve cities 18 per cent, in reserve cities 15 per cent, and in the country 12 per cent, of demand deposits, with 5 per cent against time deposits, both the proportion to be kept in the reserve banks and the rate of transfer being altered, as compared with the House bill, in such a way as to make the process of transfer easier for the contributing banks. By way of still further lightening the burden, which, it was supposed, would be imposed upon the banks in this process of transfer, it was provided that one half of the credits to be established with the reserve banks created under the bill might be paper eligible for rediscount, while the notes issued by the reserve banks were also allowed to be counted in the reserves of these member banks. The Senate bill, moreover, extended the provisions of the so-called Aldrich-Vreeland law of 1908, and inserted in the measure a provision authorizing the Secretary of the Treasury to sell bonds for gold, should such a measure be necessary at any time to maintain the redeemableness of federal reserve notes. Lastly, the Senate bill largely altered the provision which had been made in the House for the collection of checks and drafts at par throughout the country. While under debate in the Senate, the bill underwent some further alterations, none of which, however, materially changed its more important aspects as already described. Such clauses as were inserted were intended mainly to clarify the language or to add further safeguards which had been found or thought to be necessary here and there as the work proceeded.

Little needs to be said of the debate in the Senate. Much of it was distinctly partisan in tone, only an occasional argument

based upon independent data being offered. Political opponents, both Progressives and Republicans, thought to assail the work of the Democrats and to discredit it as a means of making political capital. It is doubtful whether any important provision was altered on the floor as the result of discussion, although a few points at which the measure was weak were subsequently rectified, probably as a result of the repeated attacks to which they had been subjected during the weeks before the measure was finally adopted. As the bill ultimately passed the Senate, it differed from the plan of the House in no respect that was of theoretical importance. It retained the provision for sales of stock to private holders and for the voting of the stock by trustees representing these holders, as well as for the purchase of stock by the United States itself, in case of necessity for so doing. It, moreover, introduced a change in the method of distributing the earnings of federal reserve banks whereby a portion of those earnings was to be employed for establishing a fund for guaranteeing the deposits of member banks which had taken stock in the federal reserve banks of their district. It altered the number of banks by cutting it to no less than 8 and not more than 12, in place of the "at least 12" of the House bill. While many minor changes and alterations of wording were made throughout, they did not alter the essential structure of the plan, but in some cases carried it further than the framers of the House measure had been able to do, embodying ideas that had been urged by them while the measure was under discussion, but for which they had not succeeded in obtaining endorsement. Perhaps the most injurious features which were added during the Senate stage of the measure were the provision cutting reserves of member banks to too low a point and that permitting the introduction of bank notes into reserves as a constituent element therein.

It is now necessary to pause for a moment to consider a countercurrent in the legislative history of the measure in the Senate. During the time the bill was under consideration in the Senate committee on banking, a serious political breach had occurred between the administration and its supposed friends. Three Democratic senators who were hostile to the ideas of the Federal Reserve Act had prevented an early unanimous report following the lines of the House bill, and, while two of them had subsequently sunk their differences of view, one had refused to do so and had joined with the political opponents of the measure. The committee was

thus divided into two portions, the one consisting of administration Democrats and those who voted with them, while the other consisted of old-time Republicans, Progressive Republicans, and one anti-administration Democrat. These two sections were numerically equal and both reported bills. That of the amalgamated opposition already described provided for but four reserve banks, and in various other particulars was considerably at variance with the terms of the official measure, which had ultimately been presented by the administration section of the committee. By a resort to caucus action which was early determined upon, it was possible to enlist a majority of two votes on the side of the official draft of the measure which in its ultimate form closely followed the House bill, as has already been indicated. The measure reported by the other section of the committee figured to some extent and was ultimately brought to a vote as a proposed amendment, but was defeated by the majority of two already referred to.

The substance of the work done in conference committee may be summarized somewhat further in order to bring out the points that had been accepted as innovations upon the House bill and those that have been rejected because the changes proposed in them were not deemed wise. Turning first to the alterations in the House bill that secured acceptance, the principal features may be enumerated as follows:

(1) Introduction of provision for sale of stock in federal reserve banks to the public in the event that not enough banks subscribe for the stock to furnish an adequate capital in any given district.

(2) Provision for alternative voting in the choice of directors of federal reserve banks so as to insure prompt election.

(3) Reduction of number of federal reserve banks to not more than 12, as against the "at least 12" of the House bill.

(4) Elimination of requirement that all national banks recharter.

(5) Broadening of powers of Federal Reserve Board and modification of language relating to rediscounts between federal reserve banks, so as to render such rediscounts easier than was intended by the House bill.

(6) Provision that the Secretary of the Treasury might, not must, deposit public funds in reserve banks.

(7) Reduction of reserve requirements placed upon member banks under House bill.

On the other hand, the following important points were yielded by the Senate in the conference:

(1) Omission of provision that holders of stock sold to private individuals (if any) should have voting power in directorates of federal reserve banks and elsewhere.

(2) Elimination of guarantee of bank deposits, by use of surplus earnings.

(3) Elimination of provision that federal reserve bank notes might be counted in reserves of stockholding banks.

(4) Restoration of provision that many classes of checks should be collected at par throughout the country, and that where such par collection was not enforced the charge for making collection should be fixed by the Federal Reserve Board.

(5) Elimination of domestic acceptances, thereby excluding them from use by stockholding banks and from rediscount by federal reserve banks.

(6) Modification of reserve requirements as formulated by the Senate so as to require actual cash reserves in the vaults of country banks (the Senate having entirely dispensed with such reserves after twenty-four months after date of the passage of the act) and general stiffening of reserve requirements made by the Senate, although the final language still constituted a reduction below the House provision.

(7) Reduction of period of maturity for which discountable paper might run from 180 days to 90 days.

While many other points of modification and concession on either side might, of course, be enumerated, it is believed that the foregoing presentation is representative and shows sufficiently well the nature of the conference work and the character of the points conceded on either side. Assuming that such a fair or representative selection has been made, it is evident that the work of the conference resulted in the establishment of the House contentions at nearly every essential point, the exceptions to such a remark being found in two main particulars: (1) the reduction in the number of reserve banks and their limitation to not more than 12 at any time, and (2) the provision that public deposits might or might not be made in the reserve banks at the discretion of the Secretary of the Treasury. While other points were significant and important in their way, it can certainly be fairly concluded that on those matters involving important issues of theory the House virtually held its own in most respects. In

fact, it is an accurate generalization that the final bill as completed in conference committee and as passed by both Houses was a closer approach to the original House draft of the measure than anything that had intervened during the time the bill was going through the various permutations to which it was subjected in its slow progress from one stage to another of the legislative process.

At one other point there was marked and vital departure from the original House measure—the provision with reference to the refunding of United States 2 per cent bonds and the treatment of the currency based upon such bonds. On this subject the final action of the conference was nearly equivalent to the acceptance of a plan formulated by the administration and designed to take the place of all of the various other schemes that had been recommended from different sources in either House. The action as to bonds was, therefore, not a concession by either side but was a virtual surrender by both and an acceptance of the conclusions of the Treasury Department. Barring the two matters already mentioned, the House measure was changed in no respect that affected its essential working; nor could it be said that even in these particulars it had necessarily been subjected to modification, since, in both, the action contemplated by the provisions ultimately adopted was permissive rather than compulsory.

II

What was the origin of this measure? We have already seen, in outline, how the bill had been developed by a gradual process of study under the auspices of a sub-committee of the House Banking and Currency Committee. The student of currency history in its analytical aspect will not, however, be satisfied with this as an explanation of the new measure, but will seek to know from what ultimate sources and with the use of what materials the measure was constructed. The answer to be given to such a question is necessarily complex. The Federal Reserve Act is the product of a lengthy course of development and has grown gradually out of the discussion and analysis of the past twenty years. It is not drawn, even largely, from any single source, but is the product of comparison, selection, and refinement upon the various materials, ideas, and data, rendered available throughout a long course of study and agitation. Many bills embodying the same general line of thought that now finds expression in the new act have been offered in Congress; some have been suggested outside

that body. The most fundamental concept of all—that of uniting the banks of the country into organized groups—is found in the clearing-house organizations, which in time of stress have pooled their resources and converted bank assets into the equivalent of reserve money. The bills prepared by or under the direction of Hon. Isidor Straus, Hon. J. H. Walker, Hon. Charles A. Fowler, and Hon. Maurice L. Muhleman have supplied at least the basis for many of the detailed analyses and methods of treatment that are found in the Federal Reserve Act. Earlier than any of these, was the bill recommended by the Indianapolis Monetary Commission, which did not provide for coöperative unions of banks, but upon which the framers of the present act have evidently drawn for some of their ideas. The latest bill in the long series which was available for study to the framers of the Federal Reserve Act, was that prepared for the National Monetary Commission and called in popular language the "Aldrich bill." By many the new law is regarded as a partial copy of, or plagiarism from, the Aldrich bill; and that view has been widely expressed both in and out of Congress. That such was not the opinion of Mr. Aldrich himself, his scathing and bitter denunciation of the House bill seems to bear abundant witness.[3] It might be enough for purposes of argument simply to appeal on this point from the critics of the measure to Mr. Aldrich himself but that would hardly answer the purpose of historical analysis. The Aldrich bill may be considered from two standpoints, (1) that of its theory and broad general plan on the one hand, and (2) that of its machinery and technique of construction on the other. From the first standpoint, there is no shadow of relationship or similarity between the Federal Reserve Act and the Aldrich bill. From the second, there is at many points a close resemblance. The Aldrich bill provided for a single central "reserve association" with scanty public oversight, with control vested practically wholly in the banks, and with the preponderance of power in bonds of the larger institutions which owned stock. It so arranged things as to keep this "reserve association" relatively inactive except upon special occasions of panic or disturbance. It made no direct provision for the shifting of reserves in part from existing banks to the proposed association, but it relied upon inflation due to the placing of bank notes issued by the central association in the reserves of the stock-

[3] *Proceedings of American Academy of Political and Social Science,* October, 1913.

holding banks for protection in time of danger. The new act provides for 12 reserve banks, introduces the principle of local control, calls for strict government oversight, shifts reserves from present correspondent banks to the new institutions, minimizes the influence of the larger banks in directorates, and generally diffuses control instead of centralizing it. It leaves banking as such to be practiced by bankers; it vests the control of banking in the hands of government officers. The theory and purpose of the new act are widely different from those of the Aldrich bill. Where the Aldrich proposal veers widely away from the tendencies that have been developed during the preceding ten years of American banking discussion, the Federal Reserve Act closely follows them. Indeed, the act of 1913 is closer to any one of half a dozen bills of former years than to the Aldrich proposal.

From the standpoint of technique, as already noted, the case is quite different. With regard to stock issues, kinds of paper eligible for rediscounts, and not a few other particulars, the Federal Reserve Act follows lines laid down in the measure which bore the name of Senator Aldrich. In fact, the original House bill, for strategic purposes, retained wherever it could safely do so, the language of the Aldrich bill as regards banking technique, its framers recognizing that by so doing they enormously reduced the hold of the opposition and immensely contracted the field within which the familiar charges of "unsoundness" could find scope. The decision to follow this plan for strategic reasons was amply warranted, as the subsequent conflict with the banking interest showed—that interest having repeatedly endorsed the Aldrich bill, and being, therefore, forced into constant conflict with itself in its criticism of the new measure. The fact that its leading representatives were so early reduced to vague charges of "socialism," "coercion," and "inflation," or "contraction" (according to the bias of the speaker of the moment) clearly demonstrated the difficulties to which they were subjected by the methods employed in preparing the draft of the Reserve Act. Moreover, the most desirable features of the Aldrich bill were found in its sections dealing with banking technique—upon which some of the country's best banking ability had been expended. The "theoretical" portions of the Aldrich bill were of no value whatever to any save a student of methods for producing monopoly. The Aldrich bill and its accompanying documents, in short, contained no revelation of financial wisdom. Nor was there anywhere in those limited portions of

the commission's work which proved of service, a thought not within reach in familiar European banking literature.

Perhaps the most notable and beneficial changes made by the Federal Reserve Act—the transfer of reserves from reserve to central reserve city banks and the provisions for par collection of checks whenever possible—were not mentioned either in the Aldrich bill or in those of its predecessors already referred to. They were not only new elements in the movement but were undoubtedly among the elements in the measure which proved hardest to enact into law. From the beginning, the most strenuous opposition was offered to them, notwithstanding that both features were admitted to be sound in principle. It was, therefore, only after a sharp contest that they succeeded in gaining a definite foothold, inasmuch as they constituted a new and distinctly distasteful element in the whole legislative proposal.

A review of the detailed provisions of the measure shows, therefore, that, while the conception of banking reform upon which it is founded is the same that has constituted the staple of the banking reform movement of recent years, and while the conception of a union of banks is directly borrowed, as in other bills of the past decade, from the actual practice of the banks themselves as developed under the stress of circumstances in the form of clearing-house organizations; while, moreover, certain phases of the technique of the legislation itself followed the lines of the Aldrich or Monetary Commission bill, and while other portions of the act have been adapted from well-known legislative proposals that have figured within the past few years of banking discussion, the act as a whole is based upon a conception and plan entirely its own, applies in many fundamental respects methods of control and administration that have been given at least a new form, and includes several important innovations, not heretofore conspicuous in banking discussion although admittedly significant, not to say necessary to any thorough reorganization upon sound principles. That the act also contains some elements that may be regarded as reminiscences of the less desirable and more objectionable phases of banking agitation, is equally certain. These are seen in the underlying concept of the federal reserve notes, which are thought of as government currency loaned to banks, and are thus at least theoretically, although not practically, in line with so-called "government currency" schemes of past years.

Other defects of treatment inherited from the past agitation of

the subject are seen in section 18 dealing with the retirement of government bonds, in which is perpetuated the view that, if possible, bond-secured currency must be maintained at something like its present level in order to insure the existence of the "needed money" in the country independent of the "elastic currency" provided for by the terms of the enactment. It is probable also that in several of its provisions designed to prevent the participation of bankers, or those who are interested in banking institutions, in the management of the new system, the legislation will be regarded as open to criticism and as having drawn too heavily upon radical proposals of former years. One of these may be cited as an example. Under the guise of a clause revising the visitatorial powers of the government with respect to banking institutions (section 21), there is inserted in the measure an implied authority for the examination of banks by congressional committees—a power which was proposed during the so-called Untermyer reform movement directed against the "Money Trust" in 1912, but which was then refused by Congress. It will be pretty generally conceded, even by "conservative" critics, that none of those particulars in which the new measure has been influenced by past legislative currents popularly regarded as unsound is very serious in its practical effect. The fact will remain that the influences have been present and that the bill bears the marks of the struggle through which it passed and of the varying views of widely different minds which had to be consulted or considered in connection with its making. All this is so unmistakably true that it must be recognized even by hasty students of the history and origin of the legislation of 1913. It has thus not owed its inspiration to any single source, notwithstanding that the underlying and guiding principles of its composition are those which have been long since recognized as being the necessary basis for genuine banking reform in the United States. It is a notable fact that many of those who have, after a cursory study, attributed a given origin to the measure, and have most positively asseverated its resemblance to given examples of legislation, have subsequently, upon closer acquaintance with its terms, seen good reason to alter their position and have wholly abandoned their earlier attitude of mind.

III

It is now necessary to devote some attention to the new legislation from the broad general standpoint and to note the signifi-

cance of the measure as it finally became law. To the student of banking it need hardly be said that the striking aspects of the legislation are these three: (1) the creation of a general discount market for commercial paper; (2) the systematic pooling of reserves of existing banks; and (3) the provision of an elastic currency. In the multitude of details provided by the legislation, and in the various adjustments rendered necessary by it with respect to government deposits, bank reserves, examinations, and other more or less important matters, it is noticeable throughout that everything done has been for the purpose of promoting the objects already enumerated, and of insuring the transformation of American banking from its present basis of organization to its new proposed type of effort. If these chief objects shall be accomplished in actual practice, the legislation will have been amply warranted, and, it need hardly be said to a professional reader, will completely revolutionize the banking and credit situation, to the great profit not only of the banks themselves but of their customers. That the banks will greatly profit under the bill is susceptible of easy mathematical demonstration. That the business public will profit in a far higher degree than the banks is less obvious but is a fact which constitutes the chief basis for the legislation. Were it not true, the time and effort expended in securing the present result would scarcely have been warranted. In its real essence, the new law is in fact and in the best sense of the term a "business man's measure."

Heretofore, American banking has been too largely an agency in the service of speculation. This statement is borne out by the following considerations: (1) The rates controlling the flow of gold out of the United States have been those dictated by the call loan market, not those prevailing in the commercial discount market; (2) the funds which the banks desired to have ready to hand have been customarily invested in demand loans on stocks rather than in quick commercial paper or short-term foreign exchange; (3) in times of crisis or pressure, the banks have shortened loans in this country instead of, as in foreign countries, enlarging them to accommodate legitimate borrowers. If they have undergone sacrifice, it has been for the primary purpose of upholding and safeguarding the stock market.

The new act changes this condition in the following ways: (1) It transfers a small but necessary fraction of the ultimate reserve money of the country to government-inspected institutions, lo-

cated in various parts of the country, where they will be quickly responsive to, and in sympathy with, business necessities, and prescribes by rigid rules that these funds shall be applied solely to commercial needs and to nothing else, since the loans that may be made by these new banks are narrowly restricted in term and in character; (2) it broadens the methods of doing business allowed to national banks, so far as relates to investments in legitimate commercial paper, and narrows them correspondingly, so far as relates to investments in stocks and bonds; (3) it increases the loaning power of the banks of a given community, and promises to such banks, when in need of assistance, the support which will be derived from the combined resources of their fellow banks in the same community or region. Its effort is thus to promote the growth of commercial credit and to protect that credit when brought into existence. It differs from the present law, in that it refuses longer to look upon the business man as one who "borrows money" at a bank, and regards him as one who manufactures a commodity—commercial credit and the paper representing it—which he sells to banks, and which it is the function of the latter to insure and to keep liquid. It regards the duty of the bank as being, above all things else, that of maintaining specie payments and sustaining the solvency of the community; and it declines to consider the banker as one whose duty it is to promote enterprises, float issues of securities, or aid in stock speculation. That all these phases of financial effort have their place—a desirable place when properly defined and recognized—the act fully concedes, but it holds in principle that that place is not found in connection with the work of commercial banks.

If the business community contents itself with simply continuing its present methods of operation, it will derive great advantage from the law. It will find: (1) that local banks will be able, by rediscounting the paper of local enterprises, to provide the funds needed by such enterprises in their operations; (2) that there will be no such wide fluctuations of interest rates either geographically or from season to season as now exist; (3) that there will be no necessity of emergency measures to safeguard the country from the possible results of financial panic or stringency. Credit will be more simply available, cheaper, and more equitably open to all. Not the least advantage to the business man will be found in the provisions with respect to bank examinations; since through these, it may be hoped, many operations which have been

the disgrace of American banking in the past will be early detected and corrected before they have had time to eat out the heart of institutions which might otherwise have continued sound and solvent. This is equivalent to saying that, under the new law, credit, even if there be no change in business methods, will be cheaper and more evenly diffused, as well as more steady and more certainly to be counted upon by those who do business by acceptable methods. But the community will not gain the greatest advantage from the measure if it adheres merely to established types of operation. The new act provides for the creation of a true discount market, such as has existed for many years in every European country. This means that every merchant of established local credit may in the future count upon a free sale for his paper throughout the reserve district in which he is situated, and to a somewhat lesser degree generally throughout the country. The rediscount principle, when fully worked out, taken in connection with the use of the acceptance system, will enable the sound, even though small, manufacturer or trader to get the advantage of the best rates of commercial credit that prevail anywhere within his region of the country. If there is capital to spare—unemployed and seeking occupation—he may expect that, through the general sale of bills under the new system, such capital will be available for the purchase of his paper and will be so employed. By the judicious use of the acceptance, the local bank will be enabled to facilitate the movement of goods into and out of the country, and will at once make the utmost of its own capital and at the same time enable its clients to gain the widest employment for their own resources. The net result of these various influences should be: (1) considerable reduction in average rates of interest on commercial paper throughout the United States, (2) very great reductions in the rates in certain sections remote from commercial centers; (3) stability and certainty in distribution of credit; (4) creation of new and more convenient types of paper.

Not the least important of the provisions of the new measure is that which assures to the business man the cheaper collection and transmission of his funds. The act provides for the deposit of many classes of checks and drafts at par with federal reserve banks, and it thereby aims to establish a parity of exchange among banks within every federal reserve district and then between the federal reserve banks themselves. It permits charges to

be made by member banks that correspond to the actual cost to them of collecting funds for their clients, but it places these charges under federal control and specifically authorizes the Federal Reserve Board to restrict them by rule. This is as it should be. In years past American commerce has suffered severely from the infliction of high, not to say, excessive, charges for check collection upon business men throughout the country. So far has this type of extortion been carried that it was testified by country banks during the past summer that in many instances fully one half of their earnings were due to such charges, and that they could not get along without them. Such exorbitant rates were maintained by agreements among banks and the development of a code of what is called "banking ethics," whereby banks were prevented from cutting the excessive charges had they been so minded. Much of this evil may be expected now to disappear. The banks will be restricted, when the system is fully in operation, to moderate rates; and thereby a great burden will be lifted from the backs of the commercial community. In the opinion of some, this burden will in part be removed by the process of clearing checks instead of collecting them, which is to be inaugurated under the new system. But whether it does so disappear or not, the merchants of the country will be relieved of the excess charges made by the banks in the way already indicated. In many instances this will save thousands of dollars annually to individual firms.

A less direct, although most important, aspect of the new law in its relation to business is seen in the economy of gold that will be effected under it. The original bill provided for maintaining reserves at about their present height, in the belief that ultimately the governing board would let them all down to the level prescribed for country banks. The final act makes a very great reduction in reserve requirements and will release a great volume of money after all new needs for the reserves of the federal reserve banks have been complied with. That this will produce some danger of inflation during the transition period—a danger that will need to be carefully guarded against by the best sense of the banking community—is evident. After that period has been passed, the reduction in the amount of gold that must be carried constantly in bank vaults will really be far-reaching. The United States has for many years been obliged by its antiquated banking methods to use much larger gold reserves than any other country

in the world in proportion to business done. This was as much a waste as any other unnecessary employment of capital. It meant that the actual cost of operating a bank, which had to be recovered from borrowers in interest charges, was greater in proportion to the enlarged expense of carrying an unnecessarily high reserve. This cost in turn was heightened in times of panic by the very great expense that had to be incurred for the sake of getting more gold with which to build up the reserves when the latter had been depleted. By lessening this important item of cost in banking and by reducing the exceptional and sporadic elements of cost growing out of panic conditions from time to time, reductions of interest rates will be rendered feasible and will ultimately transfer their effect to the commercial world. In this same connection it deserves to be noted that the new system will also render the control of the country's gold supply much easier and simpler. It will provide the machinery for dictating, upon occasion, changes in rediscount rates intended to prevent exportation, and upon other changes intended to aid importation. The mechanism will be automatic and effective and will replace the antiquated, costly, and not very effective methods that have had to be followed in the past. This will directly aid the man engaged in foreign trade and will immensely assist in the management of foreign exchange operations. Exchange will be furnished at much less cost to the community and our rates of exchange will be much more closely harmonious with those of the rest of the world.

In times past, there has been constant and well-founded complaint that American business men engaged in foreign trade or operating branches of their houses abroad were obliged to depend upon foreign banks for their accommodation or else finance themselves practically unaided. Where, as in the South American trade, it has been necessary for the American business man to resort to branches of European banks established in the various countries, it has been asserted that such banks, working as they did in close harmony with merchants of their own nationality, were often unfaithful to their American clientele, allowing competitors to know their business operations, and, when disposed to do so, cutting off their credit in favor of such rivals. These charges have had more or less foundation, and it has certainly been true that the banking accommodation of Americans engaged in foreign operations has been poor even at the best. Under the

new law, banks of moderate capitalization may, under the supervision of the Reserve Board, establish branches in foreign countries, and operate them subject to very broad and liberal terms of business management. This should end the constant complaint about lack of banking accommodations and should place Americans in the foreign trade upon a footing of equality with foreign competitors. It is true that, as has recently been noted, the United States lacks a supply of well-trained bank managers acquainted with foreign practice and ready to expatriate themselves for the time necessary to carry on a branch office elsewhere. Such shortage of trained men will, however, be overcome as soon as opportunity of a real sort is offered, just as the lack of well-prepared consuls has already been overcome in a very large degree, since the consular service was placed, at least partially, upon a footing of efficiency, and promotions made in a measure according to merit. It may be confidently expected that American foreign trade will within a short time be afforded all the assistance that it can reasonably call for under the very liberal provisions now made for foreign branch banking.

The general management of the new system has wisely been taken, in part, out of the hands of bankers; and has been placed, in a measure, in those of men representing commerce, industry, and agriculture. This is not because of distrust of bankers or because of a feeling that special discrimination should be shown in favor of given classes in the community. It is due to a feeling, everywhere recognized, that the industrial portion of the community should be given a voice in the management of the commercial credit of the nation, and that banking is, in its highest and best sense, a semi-public function, carried on, not merely as a means of profit, but for the sake of providing for social wants in the creation of credit and the maintenance of redemption. The business man, in the best sense of the word, is expected to take a living and direct part in the work of carrying on the new system, no matter whether he owns stock in any bank or not—and perhaps the more freely if he does not own such stock. He will thus be drafted into service because of the significance of banking to every class and section of the country, and because of the perception that it, like transportation, is no longer to be considered solely a private money-making industry.

To get the full advantage of the system, the business man needs to arouse himself to a new conception of his functions and duties.

He needs to bring his methods of borrowing and his view of commercial paper into harmony with European practice, to accustom himself to prompt payment of notes and bills without extended renewals and to the putting of his business upon a short-term cash basis. He needs further to familiarize himself with the idea of banking in the larger sense as distinct from a mere note-shaving and stock-manipulating occupation, and to prepare to share actively in the management of the new reserve banks and their branches, in which important places have been reserved for him. When he has fully developed himself along these lines, he will find the new legislation perhaps the most important step in the progressive development of business, in the broader sense of the word, that has for many years been taken by the federal government. It has the distinction, almost unique among recent acts of legislation, of being not a restrictive or hampering but a constructive measure in its purposes and methods. Much of its success will depend upon the business man and his attitude toward it.

IV

Little has been said, in the foregoing discussion, of the technical aspect of the new banking measure, its effect upon the types of commercial paper employed by the community, its probable alteration of the distribution of reserves throughout the country, or its influence upon competition between banks. In each of these fields the act will produce a very great and far-reaching transformation. To indicate the limits of this transformation, to show exactly how the new machinery must be put into operation and the points at which difficulty will be encountered, would involve a more extended treatment than can be afforded within the limits of this paper. Each one of the topics indicated, as well as several others that might be suggested, calls for elaborate and detailed study, and cannot be dealt with without danger of error—at least, until some further experience has been obtained under the law as an actual working factor. The time will come in the near future when precise statements can be made regarding the exact nature and extent of the changes necessarily to be expected under this statute. First among the events which will greatly contribute to clarification will be the action taken by the reserve bank organization committee, now at work, in the division of the country into banking districts.

HENRY PARKER WILLIS.